

**THE OFFICE OF REGULATORY STAFF
SURREBUTTAL REHEARING TESTIMONY
AND EXHIBITS
OF**

DANIEL F. SULLIVAN

AUGUST 29, 2018



DOCKET NO. 2017-292-WS

**Application of Carolina Water Service, Incorporated for
Approval of an Increase in Its Rates for Water and Sewer
Services**

SURREBUTTAL REHEARING TESTIMONY AND EXHIBITS OF
DANIEL F. SULLIVAN
ON BEHALF OF
THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF
DOCKET NO. 2017-292-WS
IN RE: APPLICATION OF CAROLINA WATER SERVICE,
INCORPORATED FOR APPROVAL OF AN INCREASE IN ITS
RATES FOR WATER AND SEWER SERVICES

**Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND
OCCUPATION.**

A. My name is Daniel F. Sullivan. My business address is 1401 Main Street,
Suite 900, Columbia, South Carolina, 29201. I am employed by the South Carolina
Office of Regulatory Staff ("ORS") in the Audit Department as the Deputy
Director.

**Q. ARE YOU THE SAME DANIEL SULLIVAN WHO PRESENTED DIRECT
REHEARING TESTIMONY IN THIS DOCKET?**

A. Yes. I pre-filed direct rehearing testimony in this docket on August 16,
2018.

**Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL REHEARING
TESTIMONY?**

A. The purpose of my surrebuttal rehearing testimony is to address the rehearing
rebuttal testimony of Michael Cartin filed on behalf of Carolina Water Service, Inc.

1 (“CWS” or “Company”) and to provide additional support for the use of pro forma
2 adjustments such as normalization adjustments.

3 **Q. SHOULD PRO FORMA ADJUSTMENTS BE MADE TO TEST YEAR**
4 **DATA FOR RATE CASES ?**

5 **A.** Yes. According to the rehearing rebuttal testimony of Company witness
6 Michael Cartin on page 1 of 7, line 13, the rate case should be based on the test
7 year. This contradicts the application filed by the Company, as the Company made
8 multiple pro forma adjustments to adjust test year data to reflect the level of
9 expenses expected to occur in the future, and to include plant additions subsequent
10 to the test year. Examples of the adjustments proposed by the Company to adjust
11 test year data include the adjustment to annualize salaries & wages, the adjustment
12 to purchased water and sewer to reflect a going forward expense level, and the
13 adjustments to expenses for the removal of the I-20 sewer treatment plant. These
14 pro forma adjustments were made by the Company to annualize or adjust expenses
15 to a going forward expense level and they either increased or decreased test year
16 expense data. ORS reviewed these pro forma adjustments and agreed with their
17 propriety. ORS determined the need to propose an adjustment to normalize sludge
18 hauling expense, and calculated its adjustment, based on the process described in
19 my rehearing direct testimony.

20 **Q. WHY ARE PRO FORMA ADJUSTMENTS NECESSARY AND WHAT ARE**
21 **STANDARD PRO FORMA ADJUSTMENTS MADE TO TEST YEAR**
22 **DATA?**

1 **A.** Pro forma adjustments to annualize or normalize revenues, expenses and
2 rate base items are critical in determining the revenues necessary to cover the cost
3 of service and provide a reasonable return to the Company. Surrebuttal Rehearing
4 Audit Exhibit DFS-1 is an excerpt from *Accounting for Public Utilities*¹ that
5 specifically addresses the types of pro forma adjustments ORS implements and are
6 appropriate to adjust test year data. They are as follows:

- 7 • Normalizing adjustments (to restate the period data for abnormal
8 conditions);
- 9 • Annualizing adjustments (to extend over the period, or to eliminate from
10 the period, events that had partial period effects and are either recurring or
11 have terminated);
- 12 • Out-of-period adjustments (to assign properly events of the period to the
13 period);
- 14 • Attritional adjustments (to recognize changing conditions, including
15 annualizing of conditions, updating of conditions, or adjusting for any
16 known and measurable changes in events or conditions that will affect
17 future cost or revenue levels); or
- 18 • Reclassified items (to add or remove items for purposes of rate recovery).

19 **Q. DID THE COMPANY PROPOSE TO ADJUST CONTRACT OPERATIONS**
20 **FOR THE FRIARSGATE WASTEWATER TREATMENT PLANT AS**

¹ Robert L. Hahne & Gregory E. Aliff, *Accounting for Public Utilities*, § 7.05 (2017).

**PART OF ITS APPLICATION, DURING THE ORS AUDIT OR AT THE
MERITS HEARING IN APRIL?**

A. No. The Company did not propose an adjustment to adjust for contract operations at its Friarsgate wastewater treatment plant in its application, during the ORS audit, or at the merits hearing on April 3-4, 2018.

**Q. DID YOU PREPARE ANY OTHER EXHIBITS AS PART OF YOUR
SURREBUTTAL REHEARING TESTIMONY?**

A. Yes. I prepared Surrebuttal Rehearing Audit Exhibit DFS-2 and Surrebutal Rehearing Audit Exhibit DFS-3 to update the equalization basin adjustment, as discussed in the surrebuttal rehearing testimony of ORS witness Dawn M. Hipp, as well as all fall out adjustments and the ORS proposed rehearing decrease.

**Q. WHAT WOULD BE THE EFFECT ON THE COMPANY'S REVENUES IF
THE PSC WERE TO ACCEPT ORS'S PROPOSED ADJUSTMENTS
UPDATED THROUGH SURREBUTTAL TESTIMONY?**

A. Surrebuttal Rehearing Audit Exhibit DFS-2 shows the result of ORS's updated proposed adjustments based on the PSC approved return on equity of 10.5% would be a net reduction to revenues for the Company of \$116,185.

Q. DOES THIS CONCLUDE YOUR REHEARING TESTIMONY?

A. Yes.

ACCOUNTING FOR PUBLIC UTILITIES

Volume 1

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Contributing Authors: The following were the original contributing authors of Accounting for Public Utilities. While much of what these individuals originally wrote has been removed or replaced through the annual update process, we wish to continue to recognize their contributions in the creation of this book.

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Filed Through:
RELEASE NO. 34, November 2017

§ 7.05 Pro Forma Adjustments to the Test Year Data

Under changing conditions, especially in an expanding system, the use of a test year, other than one based on fully forecasted data, will create a critical need for pro forma adjustments. Even in stable conditions, historical data will likely require restatement for actual occurrences not expected to recur or for events that are expected to occur but did not exist (in whole or in part) in the test year. Further, there may be events that did occur and are expected to continue but the related costs are not deemed the customers' responsibility. The pro forma adjustments that are normally utilized fit into one of the following categories:

- (1) normalizing adjustments (to restate the period data for abnormal conditions);
- (2) annualizing adjustments (to extend over the period, or to eliminate from the period, events that had partial period effects and are either recurring or have terminated);
- (3) out-of-period adjustments (to assign properly events of the period to the period);
- (4) attritional adjustments (to recognize changing conditions, including annualizing of conditions, updating of conditions, or adjusting for any known and measurable changes in events or conditions that will affect future cost or revenue levels); or

Surrebuttal Rehearing Audit Exhibit DFS-1

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TEST PERIOD COST OF SERVICE

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- (5) reclassified items (to add or remove items for purposes of rate recovery).

Normalization adjustments are usually made to revenues or to expenses to offset for unusual operating events leading to these adjustments. Events that lead to normalization adjustments tend to have an extraordinary and non-recurring impact on operations. For example—

- (1) Extreme weather conditions can create abnormal levels of sales and/or costs during the period;
- (2) Normal levels of operations may be delayed or may be accelerated during the period; or
- (3) Extended plant outages may create unusual costs.

Such events, when of an abnormal or nonrecurring nature, require adjusting the test year to a normal, ongoing level of operation.

One consideration in identifying extraordinary and nonrecurring events that justify normalizing adjustments is whether the event actually has an extraordinary and nonrecurring impact on operations. Many events, if viewed in isolation, might be considered extraordinary or nonrecurring, but if viewed from an overall operating perspective, might be a part of the routine cost of doing business. For example, a car owner may have an unexpected and costly generator failure at one point in the car's lifetime. A battery failure may, however, occur at some other time, or a starter failure may occur, and so on. Any one of these failures may be a one-time, nonrecurring event, but a different one may occur each year. Any one of the specific problems may be nonrecurring but will be replaced by other problems, and the annual cost of operating the car may therefore be normal. It is in this context that the normalizing adjustments should be considered.

Annualizing adjustments recognize that some conditions existing during segments of the period are ongoing and must be spread over the entire period. One common annualizing adjustment is for wage increases that occur during the test year. Since wage costs will be greater on an ongoing basis than as recorded, the adjustment is necessary to improve the prospective status of the test year data. The key ingredient in the annualizing adjustment considerations is the changing level of costs (or revenues) for the same level of operations. If the change expands or reduces operations, the investment/revenue/cost relationships may all change equally and an adjustment may not be needed. For example, a growing system will be adding new investment, new employees, and new sales. The changes related to growth may not require annualization to maintain the interrelationships between investment levels, revenues, and costs.

Out-of-period adjustments are required when an event is recorded in one period but applies to another period. One common out-of-period adjustment is income tax expense which may include prior period tax assessments or rebates from prior periods. When using recorded test year income taxes, any out-of-period amounts in the tax expense accounts should be eliminated.

Attritional adjustments restate conditions as recorded during the test year to levels that may be reasonably anticipated for test period purposes (i.e., representative of

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future conditions). Since this category of pro forma adjustments includes any restating of conditions from those recorded to those anticipated, it could include most, probably all, of the annualization adjustments already discussed above. In addition, and sometimes most significantly, this category includes those events that will occur but have not been included in the typical pro forma adjustments to the test year data. The general role of attritional adjustments are of such import that the subject is discussed in detail in Chapter 8.

Attritional adjustments are most limited by the "known and measurable" standard. Many commissions have permitted adjustments for conditions that come into being subsequent to the test year, but only when they are known with an almost absolute finality and measurable by some explicit test year activity. A good example is the contractual obligation for post-test-year wage adjustments. The problem inherent in the explicit selection of adjustments is that many areas of change that could be identified and measured as to their impact are ignored. For example, inflationary conditions will result in higher costs for materials and supplies used in operations, but such changes often are not considered to be known and measurable.

The idea of a known change in the ratemaking framework should not be that the change is in an absolute or unchangeable form, but rather that there is a known condition or a known pattern of change in the operations. While the term "known change" may suggest something in the past, it is generally not so limited by regulators. For example, the rationale for allowing adjustments for prospective wage increases which are under a contractual arrangement is that contractual agreements have a high probability of occurring. The existence of inflation and its impact on a company's various operating costs has just as high a degree of probability as has the wage agreement. In basic character, no difference exists. Regulators "know" that the wages will be increased. They should "know" that various noncontractual areas of costs incurred by the utility will also increase. There is no reason to believe that wage contracts will not be fulfilled, and similarly there may be no reason to believe that inflation patterns are going to change significantly in the time frame used for setting rates. The "known" quality applies equally to activities with contracted price adjustments and those activities faced with general price changes.

In addition, the measurable aspects of most areas of costs are quite similar. The impact of past or prospective wage increases is measured in the test year and adjusted accordingly. Also, various other costs in the test year are adjusted for the impact of the changes that are occurring.

There is a strong similarity between adjusting for the traditional items which are prominent and easily isolated and a variety of other items which are less prominent and less easily isolated, but which have equally adverse effects. Many of the costs that are often excluded from the pro forma adjustments fit properly into the known and measurable criterion.

Reclassified items generally concern activities that are included in operating accounts under the uniform systems of accounts directives but are disallowed for purposes of fixing rates on the premise that the costs do not benefit ratepayers. The most common adjustments include the disallowance of various advertising costs,

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charitable contributions, and company involvement in civic affairs, which, although designated as operating expenses, are frequently assessed against the equity holders rather than the ratepayers through reclassification adjustments. Some jurisdictions have also disallowed expenses associated with various forms of executive compensation through reclassification adjustments.

Carolina Water Service, Inc.
Operating Experience, Rate Base and Rate of Return
Combined Operations
Docket No. 2017-292-WS
Test Year Ended August 31, 2017

<u>Description</u>	(1) Per PSC Order No. 2018-345(A) \$	(2) ORS Rehearing Adjustments \$	(3) After ORS Rehearing Adjustments \$	(4) ORS Proposed Rehearing Decrease \$	(5) After ORS Rehearing Decrease \$
<u>Operating Revenues</u>					
Service Revenues - Water	12,092,771	-	12,092,771	-	12,092,771
Service Revenues - Sewer	10,591,452	-	10,591,452	(116,500) (K)	10,474,952
Miscellaneous Revenues	527,899	-	527,899	(1,407) (L)	526,492
Uncollectible Accounts	(338,928)	-	(338,928)	1,722 (M)	(337,206)
Total Operating Revenues	22,873,194	-	22,873,194	(116,185)	22,757,009
<u>Maintenance Expenses</u>					
Salaries and Wages	2,699,723	-	2,699,723	-	2,699,723
Capitalized Time	(541,688)	-	(541,688)	-	(541,688)
Purchased Power	820,160	-	820,160	-	820,160
Purchased Water and Sewer	3,927,915	-	3,927,915	-	3,927,915
Maintenance and Repair	2,328,889	(96,892) (A)	2,231,997	-	2,231,997
Maintenance Testing	256,619	-	256,619	-	256,619
Meter Reading	110,180	-	110,180	-	110,180
Chemicals	399,940	-	399,940	-	399,940
Transportation	205,565	-	205,565	-	205,565
Operating Exp. Charged to Plant	0	-	0	-	0
Total Maintenance Expenses	10,207,303	(96,892)	10,110,411	-	10,110,411
Salaries and Wages	627,460	-	627,460	-	627,460
Office Supplies & Other Office Exp	304,108	-	304,108	-	304,108
Regulatory Commission Exp.	138,929	(14,979) (B)	123,950	-	123,950
Pension & Other Benefits	819,258	-	819,258	-	819,258
Rent	25,402	-	25,402	-	25,402
Insurance	292,007	-	292,007	-	292,007
Office Utilities	540,417	-	540,417	-	540,417
Outside Services	272,599	-	272,599	-	272,599
Non-Utility Misc Income	0	-	0	-	0
Miscellaneous	(80,508)	-	(80,508)	-	(80,508)
Total General Expenses	2,939,672	(14,979)	2,924,693	-	2,924,693
Depreciation	1,634,435	(34) (C)	1,634,401	-	1,634,401
Amortization of CIAC	(405,850)	-	(405,850)	-	(405,850)
Taxes Other Than Income	3,042,436	-	3,042,436	(611) (N)	3,041,825
Income Taxes - State	188,283	5,596 (D)	193,879	(5,779) (O)	188,100
Income Taxes - Federal	614,357	22,325 (E)	636,682	(23,057) (P)	613,625
Sale of Utility Property	-	-	0	-	0
Amort. Investment Tax Credit	(8,853)	-	(8,853)	-	(8,853)
Amortization of PAA	(15,373)	-	(15,373)	-	(15,373)
Total Other Expenses	5,049,435	27,887	5,077,322	(29,447)	5,047,875
Total Operating Expenses	18,196,410	(83,984)	18,112,426	(29,447)	18,082,979
Net Operating Income	4,676,784	83,984	4,760,768	(86,738)	4,674,030
Customer Growth	62,269	1,118 (F)	63,387	(1,155) (Q)	62,232
Interest During Construction	-	-	0	-	0
Net Income (Loss) For Return	4,739,053	85,102	4,824,155	(87,893)	4,736,262
<u>Original Cost Rate Base:</u>					
Gross Plant In Service	96,559,114	(2,242) (G)	96,556,872	-	96,556,872
Accumulated Depreciation	(12,988,919)	34 (H)	(12,988,885)	-	(12,988,885)
Net Plant In Service	83,570,195	(2,208)	83,567,987	-	83,567,987
Deferred Charges	0	-	0	-	0
Cash Working Capital	1,620,963	(13,984) (I)	1,606,979	-	1,606,979
Contributions In Aid of Construction	(20,930,124)	-	(20,930,124)	-	(20,930,124)
Accumulated Deferred Income Taxes	(7,539,472)	-	(7,539,472)	-	(7,539,472)
Customer Deposits	(336,522)	-	(336,522)	-	(336,522)
Advances in Aid of Construction	0	-	0	-	0
Plant Acquisition Adjustment	(860,085)	-	(860,085)	-	(860,085)
Total Rate Base	55,524,955	(16,192)	55,508,763	-	55,508,763
Return on Rate Base	8.53%		8.69%		8.53%
Operating Margin	13.23%		13.60%		13.28%
Interest Expense	1,713,755	(514) (J)	1,713,241	0	1,713,241

Carolina Water Service, Inc. - Docket No. 2017-292-WS
Explanation of ORS Rehearing Adjustments
Test Year Ended August 31, 2017

Surrebuttal Rehearing Audit Exhibit DFS-3

Adj #	Description	Operating Revenues \$	Miscellaneous Revenues \$	Uncollectible Accounts \$	Maintenance and Repair \$	Regulatory Commission Expense \$	Depreciation \$	Taxes Other Than Income \$	Income Taxes - State \$	Income Taxes - Federal \$	Customer Growth \$	Gross Plant In Service \$	Accumulated Depreciation \$	Cash Working Capital \$	Interest on Debt \$
ORS Rehearing Adjustments															
1	To normalize sludge hauling expenses.				(96,892)				4,845	19,330	968			(12,112)	(385)
2	To remove the amortization of litigation expenses.					(14,979)			749	2,988	150			(1,872)	(59)
3	To adjust the environmental component of the Friargate wastewater treatment plant equalization basin.						(34)		2	7	-	(2,242)	34		(70)
Total ORS Rehearing Adjustments		-	-	-	(96,892)	(14,979)	(34)	-	5,596	22,325	1,118	(2,242)	34	(13,984)	(514)

ORS Proposed Rehearing Decrease

Adj #	Description	Operating Revenues \$	Miscellaneous Revenues \$	Uncollectible Accounts \$	Maintenance and Repair \$	Regulatory Commission Expense \$	Depreciation \$	Taxes Other Than Income \$	Income Taxes - State \$	Income Taxes - Federal \$	Customer Growth \$	Gross Plant In Service \$	Accumulated Depreciation \$	Cash Working Capital \$	Interest on Debt \$
4	Adjust Revenue, Taxes & Customer Growth for the ORS Rehearing Decrease	(116,500)	(1,407)	1,722	-	-	-	(611)	(5,779)	(23,057)	(1,155)				
Total ORS Proposed Rehearing Decrease		(116,500)	(1,407)	1,722	-	-	-	(611)	(5,779)	(23,057)	(1,155)	-	-	-	-